The route to fast food franchising

Learning outcomes:

As a result of carefully reading this case study, students should be able to:

- **define** the terms franchisee and franchisor
- **explain** how brand franchising works
- **know** that franchising involves a three way relationship between franchisee, franchisor and suppliers
- **understand** how franchising enabled McDonald's to grow quickly
- **describe** 6 benefits to the franchisee of holding a franchise
- **outline** the benefits of franchising arrangements to organisations like McDonald's
- **show** how suppliers also benefit from franchising arrangements
- **understand** that successful franchising depends on the commitment of franchisees, franchisors and suppliers.

Introduction

When the McDonald brothers, Dick and Mac opened their first restaurant in 1940 in San Bernardino, California, they could never have imagined the phenomenal growth that their company would enjoy. From extremely modest beginnings, they hit on a winning formula selling a high quality product cheaply and quickly. However, it was not until Ray Kroc, a Chicago based salesman with a flair for marketing, became involved that the business really started to grow. He realised that the same successful McDonald's formula could be exploited throughout the United States and beyond.

There are now more than 29,000 McDonald's Restaurants in over 120 countries. In 2001, they served over 16 billion customers, equivalent to a lunch and dinner for every man, woman and child in the world! McDonald's global sales were over $38bn, making it by far the largest food service company in the world.

In 1955, Ray Kroc realised that the key to success was rapid expansion. The best way to achieve this was through offering **franchises**. Today, over 70 percent of McDonald's restaurants are run on this basis. In the UK, the first franchised restaurant opened in 1986 - there are now over 1,200 restaurants, employing more than 70,000 people, of which 34 percent are operated by franchisees.

This case study examines the success of franchising and investigates the special three way relationship that exists between the **franchisee**, the franchisor and the suppliers.

What is franchising?

McDonald's is an example of **brand franchising**. McDonald's, the franchisor, grants the right to sell McDonald's branded goods to someone wishing to set up their own business, the franchisee. The licence agreement allows McDonald's to insist on manufacturing or operating methods and the quality of the product. This is an arrangement that can suit both parties very well.

Under a McDonald's franchise, McDonald's owns or leases the site and the restaurant building. The franchisee buys the fittings, the equipment and the right to operate the franchise for twenty years. To ensure uniformity throughout the world, all franchisees must use standardised McDonald's branding, menus, design layouts and administration systems.

Advantages to the franchisee

1. Being their own boss

In return, the franchisee agrees to operate the restaurant in accordance with McDonald's standards of quality, service, cleanliness and value. McDonald's regularly checks the quality of the franchises output and failure to maintain standards could threaten the licence. The franchisee is also expected to become involved in local events and charities. Ray Kroc believed strongly that a business must be prepared to put something back into the community in which it operates.

The franchisee, for all the **training** and support McDonald's offers, is running his or her own business. They fund the franchise themselves and therefore have much to lose as well as gain. This makes them highly motivated and determined to succeed.

2. Selling a well established, high quality product

In this case, the product is recognised all over the world. A large proportion of new businesses and new products fail, often due to costs of the research and development needed. The McDonald's formula, however, has been successfully tried and tested. Ray Kroc's insistence that all McDonald's outlets sold the same products and achieved the same quality has led to a **standardisation** of the process and great attention to detail.

The cooking processes in McDonald's restaurants are broken down into small, repetitive tasks, enabling the staff to become highly efficient and adept in all tasks.

This **division of labour** and the **high volume turnover** of a limited menu allows for considerable **economies of scale**. For the franchisee, this can considerably reduce the risk of setting up their own business. There is no need to develop the product or do expensive market research. Nor will they have sleepless nights wondering if the product will appeal to the consumer. McDonald's carries out regular market research.

3. Intensive initial training

Every franchisee has to complete a full-time training programme, lasting about nine months, which they have to fund themselves. This training is absolutely essential. It begins with working in a restaurant, wearing the staff uniform and learning everything from cooking and preparing food to serving customers and cleaning.

Further training at regional training centres focuses on areas such as business management, leadership skills, team building and handling customer enquiries. The franchisee will have to recruit, train and motivate their own workforce, so they must learn all the skills of **human resource management**. During the final period, the trainee learns about stock control and ordering, profit and loss accounts and the legal side of hiring and employing staff. Consequently, no McDonald's franchisee would have to ask a member of his or her staff to do something that they couldn't do themselves. Knowing this, can also be a powerful motivator for the staff.

4. Continuous support

McDonald's commitment to its franchisees does not end with the training. It recognises that the success and profitability of McDonald's is inextricably linked to the success of the franchises. A highly qualified team of professional consultants offer continuous support on everything from human resources to accounting and computers. The field consultant can become a valued business partner and a sounding board for ideas.

5. Benefit from national marketing carried out by McDonald's

A brand is a name, term, sign, symbol or design, (or a combination of these) which identifies one organisation's products from those of its competitors. The phenomenal growth of McDonald's is largely attributed to the creation of its strong **brand identity**. McDonald's **trademark**, the Golden Arches, and its brand name has become amongst the most instantly recognised symbol in the world.

In the UK, McDonald's recognised the need for a co-ordinated marketing policy. In order to be successful, an organisation must find out what the customers want, develop products to satisfy them, charge them the right price and make the existence of the products known through **promotion**. Cinema and television advertising have played a major part in McDonald's **marketing mix**. McDonald's is now the biggest single brand advertiser on British television.

Radio and press advertisements are used to get specific messages across emphasising the quality of product ingredients. Promotional activities, especially within the restaurant, have a tactical role to play in getting people to return to the restaurants regularly. All franchisees benefit from any national marketing and contribute to its cost, currently a fee of 4.5 percent of sales.

The franchisees additionally benefit from the extensive national **market research** programmes that assess consumer attitudes and perceptions. What products do they want to buy and at what price? How are they performing compared to their competitors?

Any new products are given rigorous market testing so that the franchisee will have a reasonable idea of its potential before it is added to the menu. The introduction of new products, which have already been researched and tested, considerably reduces the risk for the franchisee.

Massive investment in **sponsorship** is also a central part of the image building process. Sponsorship in 2002 included:

- Football World Cup
- Olympic Games
- Community Partner of The Football Association
- The Scottish Football Association
- The Northern Ireland Football Association
- The Football Association of Wales
- PopStars: The Rivals

all of which increases awareness of McDonald's brand. However, McDonald's still follows Ray Kroc's community beliefs today, supporting the Tidy Britain Group and the Groundwork Trust, as well as local community activities.

6. Forecasting

Another major problem for a new business is predicting how much business it might enjoy, running the risk of either **cashflow** problems or the difficulties associated with **overtrading**. The turnover and profit from any outlet will vary, depending on a wide range of internal and external variables. Each franchisee is expected to take a positive approach to building up sales, although an average rate of return of over 20 percent is generally expected over the lifetime of the franchise.

The advantages for the franchisor

McDonald's recognises the benefits of a franchised operation. Franchises bring **entrepreneurs**, full of determination and ideas, into the organisation. Franchising enables McDonald's to enjoy considerably faster growth and the creation of a truly global brand identity. The more restaurants there are, the more McDonald's can benefit from economies of scale.

On the financial side, McDonald's receives a monthly rent, which is calculated on a sliding scale based on the restaurant's sales, i.e. the higher the sales, the higher the percentage and visa versa. There is also a service fee of 5 percent of sales in addition to the contribution to marketing. The purchase price of a restaurant is based on cashflow and is generally about £150,000 upwards. The new franchisee is expected to fund a minimum of 25 percent of this from their own unencumbered funds.

Dynamic innovation

Whilst the franchisees have to agree to operate their restaurants in the McDonald's way, there still remains some scope for innovation. Many ideas for new items on the menu come from the franchisees responding to customer demand. Developing new products is crucial to any business, even one which has successfully relied on a limited menu for many years. Consumer tastes change over time and a company needs to respond to these changes. Innovation injects dynamism and allows the firm to exploit markets previously overlooked or ignored. The introduction of the Egg McMuffin in 1971, for example, enabled McDonald's to cater initially for the breakfast trade. Filet-o-Fish, Drive-thru's and Playlands were all products or concepts developed by franchisees.

The three-legged stool - the suppliers

A third group of stakeholders, critical to the success of the franchise operation, is the suppliers. As McDonald's considers the quality of its products to be of absolute importance, it sets standards for suppliers that are amongst the highest in the food industry. McDonald's believes in developing close relationships with suppliers - everything is done on an open accounting, handshake trust basis.

The supplier's work closely with McDonald's to develop and improve products and production techniques. This close interdependency is described as a three-legged stool principle, and involves McDonald's, the franchisees and the suppliers. Suppliers that are able to meet the quality standards set down by McDonald's have been able to share in the growth and success of McDonald's.

Conclusion

McDonald's views the relationship between franchisor, franchisee and supplier to be of paramount importance to the success of the business. Ray Kroc recognised the need very early on for franchisees that would dedicate themselves to their restaurants. He wanted people who had to give up another job to take on the franchise venture, relying on their franchise as their sole source of income and would therefore be highly motivated and dedicated. Consequently, McDonald's will not offer franchises to partnerships, consortia or absentee investors. The initial capital has to come from the franchisee as a guarantee of their commitment. The selection process is rigorous to ensure that McDonald's only recruits the right people.

GLOSSARY

Brand franchising: The allowing of other organisations to use successful and well known branded products/services.

Brand identity: Image and values associated with a brand.

Cashflow: Cash coming in and going out of a business.

Division of labour: Breaking a job down into specific roles or parts.

Economies of scale: The advantages that result from being large which lead to reductions in average costs.

Entrepreneurs: People who use their ideas and energies to invest in a business in return for profits.

Franchisee: The person or company that buys the local rights to use the name, brand and image of another business.

Franchises: Businesses that are based upon the name, logos and trading methods of an existing organisation.

High volume turnover: Large amount of sales.

Human resource management: The development of an organisation's people.

Lease: The right to use a property or land for a limited period of time.

Marketing: The function that links a business' activities with the tastes and preferences of its customers.

Marketing mix: Group of variables – People, Price, Product and Place, sometimes known as the four P's, forming the basis of a marketing strategy.

Market research: Systematic range of activities designed to find out the views and thoughts of both potential and existing users of products or services.

Overtrading: Expansion that damages cash flow.

Promotion: Making products and services better known through a range of activities.

Sponsorship: Element of the promotional mix that allocates funds for sporting, cultural or social events.

Standardisation: The use of products that are identical and so are interchangeable.

Trademark: Logo and symbol displayed on a company's products.

Training: Education related to work.

For further information about McDonald's please browse:

www.mcdonalds.co.uk